MICHAEL J. MURPHY
State Treasurer

First Quarter 2003

The QUARTERLY

Local Government Investment Pool

The Fed's prognosis: 'We don't know ... yet'

The first quarter of calendar year 2003 affirmed that the economy has not recovered from its fourth-quarter slump.

Market strategists used the Iraq war as a convenient excuse for the economy's poor performance. Indeed, it was a very good reason and all-encompassing justification for what people don't know about the economy. It is difficult to predict whether the economy is in its recovery phase, especially if all economic indicators are weakening. It is also difficult to presume that the economy is headed for another dip when the war concludes.

The Federal Reserve unanimously agreed during the March 18 FOMC meeting not to give any direction to its usual bias pronouncements. Bias statements are crucial to market investors in piecing together the Fed's next probable moves and subsequent implications on interest rates. Federal Reserve policymakers said the war in Iraq had made the outlook uncertain and they were compelled not to give any statement about the prospects of the economy. However, after a few more weeks of very disappointing economic releases, committee members remained cautiously optimistic on their view of the economy. Some Fed members called attainable the 2.4 percent Gross Domestic Product (GDP) projections from the latest Blue Chip Economic Indicator Survey for 2003.

Clearly, the "soft patch" that Chairman Greenspan mentioned late last year remains in the first quarter of 2003. It was very evident that consumers were less enthusiastic to spend, as employees were still fearful about job losses and/or gaining full employment while corporations were hesitant to commit capital in an environment full of uncertainties. Even the much vaunted anchors of the economy, mortgage refinancing and home sales, have shown signs of weariness.

GDP came in at 1.6 percent for the first quarter of 2003, up from 1.4 percent in the fourth quarter of 2002. However, based on data released through mid-April, other economic indicators have actually worsened. The US economy lost almost half a million jobs during the first quarter of 2003. Consumer sentiment, external deficit problems, industrial production numbers and corporate earnings continued to hinder growth. There is a growing consensus from market strategists that the first half of 2003 could see below-trend growth given the weak economic performance and repercussions of rebuilding Iraq.

The economy needs more than a jump-start, as consumer confidence remains fragile. The members of the Federal Reserve board have even discussed what tools, beyond rate cuts, are left to resuscitate an ailing economy. The conclusion of the Iraq war may provide a much-needed catalyst to boost consumers' sentiment and consequently, consumption. Economists cited the need for interest rates to be kept low on the longer end of the curve to create a meaningful impact on the economy. Inflation should also remain in check for the rest of the year.

The economy has shown spurts of recovery across different sectors but not quite the overall positive indicators that economists could use to relate their figures with real economic growth. Corporate earnings were mixed but the outlook given by most CEOs was not very encouraging. The usual complaints were a no-growth scenario for capital investments and

continued on page 2

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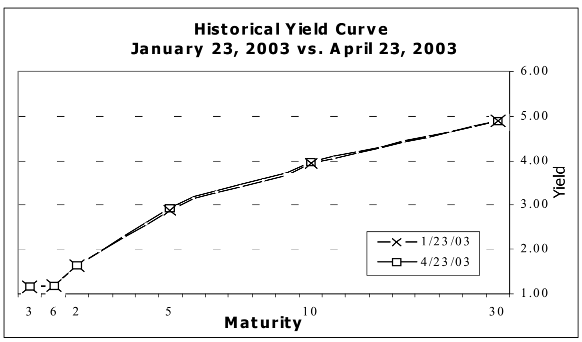
Market summary

from page 1

underutilization of production capacity. As a result, both the equities and credit markets have shown lackluster trading volume activities.

The stock market showed improvement for the first quarter of calendar year 2003. The S&P 500 and the DJIA showed 4.06 percent and 2.35 percent gains, respectively, with the NASDAQ recording an impressive 5.78 percent gain for the same period. Market players stayed on the sidelines watching events unfold in the Middle East and reacting to the day-to-day vagaries of "Operation Iraqi Freedom". The stock market rally came in late as the war reached its finality.



As the above chart shows, the bond market had an uneventful first quarter, as its market players were also mindful of the Iraq War. The yields on the three-month and six-month bills were unchanged. The 2-year notes were also unchanged but the 5-year and 10-year yields rose 6bp and 4bp, respectively. The rise in yields was due to market players taking the "war premium" off the credit markets and worries about supply due to the country's worsening budget deficit. However, there was also a consensus building that the Federal Reserve might not lower interest rates so soon and would wait for economic indicators unseasoned by the effects of the war.

With the targeted Fed Funds rate holding steady at 1.25 percent, the net return on the LGIP ranged from 1.31 to 1.28 percent during the first quarter of 2003. It becomes increasingly difficult to preserve yield as the short-term market continues to offer few investments that provide positive carry. Current market sentiment is for the next Fed move to be an ease in rates, however, there is no consensus as to when that move is likely to occur. At present, the average life of the LGIP portfolio is 68 days, representing a slightly bullish position. The portfolio is positioned to shift with any changes in the general attitude of the market.

Notes from the March LGIP advisory meeting

The LGIP Advisory Committee heard about net LGIP returns for the first quarter of 2003 at its meeting March 28 at the Office of the State Treasurer in Olympia.

The LGIP net rate was 1.45 percent for December 2002 and 1.28 percent for February. The March net rate will probably be about 1.27 percent if the fed funds rate remains at 1.25 percent. The LGIP has outperformed its benchmark by 40 basis points (bp). The average life of the pool is 50 days.

A decline in LGIP balances over the past few months has taken the total to about $4.2 billion, down from last year's high of $6 billion.

Certificates of appreciation were presented to Duane Leonard, Snohomish County Housing Authority, for his service on the committee from 1997-2003; and Doug Lasher, Clark County Treasurer, for his service on the committee from 2000-2003.

A review of the Fiscal Year (FY) 2003 budget showed LGIP balances higher than anticipated, with expenses also slightly higher. The estimated rebate for FY 2003 is $1.1 million, slightly higher than the original estimate. A chart was distributed to committee members showing the growth of the LGIP from $3 billion in 1999 to $6 billion in 2001.

A brief update on the TM$ project showed usage by participants remaining at about 60 percent. A new report soon to be available to users is similar to the account ledger, but will also include comments from the transaction entry screen. Committee members have experienced no recent problems accessing TM$.

The TM$ accounting system has been fully

continued on page 3

LGIP Advisory Committee

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State Board for Community and Technical Colleges
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Spokane County Treasurer
(509) 477-3674

Virginia "Jenny" Zacher
Franklin County Treasurer
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Treasurer Murphy Appointment
Currently vacant

Events

Don't miss WFOA 2003
Make plans to attend this year's WFOA conference in Spokane. We're working hard to redesign our Public Finance track to bring you a comprehensive program focusing on portfolio management skills. Along with ideas for using the LGIP as an investment alternative, we'll be offering "hands-on" instruction in analyzing trades and evaluating portfolios. In addition to our portfolio management lineup, we'll bring back some favorites, including appearances from OST's Bond Debt section and John Mitchell's own economic update.

For more information on the conference, visit the WFOA website at www.wfoa.org.

Welcome new LGIP participants
Help us in thanking and congratulating new LGIP participants who have become members in the first quarter of 2003:

City of Seattle

Also offered by the Office of the State Treasurer. . .

LOCAL Program
Financing solutions for local government equipment and real estate needs.

www.wa.gov/tre/local.htm

Contacts:
Sue Melvin
Equipment specialist
360-902-9022

Kristi Wolgamot
Real estate specialist
360-902-9020

Pam Johnson
LOCAL specialist
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Minutes

from page 2

implemented and the mainframe investment accounting system is no longer being used. The entire mainframe system will no longer be used effective June 30, 2003. OST is very pleased with the TM$ system and it has streamlined the duties performed by the investment section.

It was suggested that OST put together a presentation of how TM$ was developed and implemented to be used as an educational session at future conferences. Committee members agreed that would be a good idea, and OST staff agreed to proceed with this project when it is feasible.

An update on the Statewide Custody Program included a brief history of the process that led to the appointment of The Bank of New York (BONY) as the statewide custody provider. The original contract was for four years, which included an option for a two-year extension.

Based on positive comments from entities using the program, it was proposed the extension be offered to BONY. The committee voted unanimously to approve the extension. Treasurer Murphy will send a letter to BONY.

A brief report was given on investment education opportunities. The LGIP newsletter will include more articles like the new series of "Investing 101" focusing on basic investment skills. An update was given on the speakers scheduled for the WFOA conference in September.

A handout distributed to committee members showed earnings vs. transaction costs. Entities can reduce costs by effectively managing their transactions, it was explained, especially those entities that have many transactions. Committee members were encouraged to contact the LGIP administrator for assistance.

A discussion left over from the December advisory committee looked at how often meetings should be held. In researching the bylaws, it was discovered the State Finance Committee would have to approve any changes to the LGIP meeting schedule. Committee members favored retaining quarterly meeting schedule.

Committee members discussed dates for the next meeting. It was decided June was not a good month for the next meeting because of several conferences members will be attending. A July meeting date will be selected in July and committee members will be notified of that date.

OST extends Bank of New York as statewide custody provider

Treasurer Murphy has announced a two-year extension, with no fee increases, of The Bank of New York's (BONY) appointment as the statewide custody provider.

Under this program, which began in 2000 and was the first of its kind in the nation, BONY offers custody services to local governments and institutions of higher education. In addition to the attractive fee schedule and solid contract language, the legislation that created the program allows local governments and institutions of higher education to utilize the program without conducting their own search process. BNY Western Trust administers the program from its Seattle office.

In a recent survey of participating entities, all expressed positive comments, citing BONY's high level of service. At its March 2003 meeting, the LGIP Advisory Committee, which provided oversight of the initial selection process, unanimously recommended an extension. The Letter of Agreement between OST and BONY, originally set to terminate in 2004, will now expire in March 2006.

The statewide custody program, one more example of the strong partnership between OST and local governments, demonstrates the sound commitment to providing value to the citizens of this state. For more information on the program visit our website at www.wa.gov/tre/ and click on "Investments".

Investing 101: Managing average life

Part 2 – Evaluating the impact of proposed trades

The following article is part of the "Investing 101" educational series, which focuses on basic investment issues. We hope you find these articles informative and helpful. If you have comments or would like to suggest other topics for the series please call Lisa Hennessy at (360) 902-9013.

In "Managing Average Life Part 1" (The Quarterly, Fourth Quarter 2002), we focused on repricing — the concept that, at some point, a portfolio must be reinvested at the current market. We discussed the relationship between portfolio average life and the speed at which a portfolio reprices to the current market. We established the viability and significant value of effectively managing a portfolio's average life. We also explained the importance of developing average life guidelines that fit within the limitations of the investment policy, with parameters for bullish, bearish and neutral average life.

In this article we'll delve further into managing average life by evaluating the impact of potential trades. Because average life is such a valuable resource, and one that should be used wisely, the effects of every prospective trade should be considered very carefully. Following is an example of an evaluation that compares a portfolio's average life and yield before and after a proposed trade:

Current portfolio:

Size: $10,000,000 Average life: 50 days
Yield: 1.45% Cash available: $200,000 yielding 1.23%

Proposed trade:

Purchase $200,000 1-yr coupon (life of 365 days) yielding 1.51%

Step 1 - Impact to average life:

Formula: (Life of proposed trade x Par of proposed trade) / Total portfolio = # of days

Example: (365 days x $200,000) / $10,000,000
= 73,000,000 / 10,000,000
= **7.3 days**

Step 2 - Impact to yield:

Formula: [(Proposed trade yield – Cash yield) x (Par of proposed trade)] / Total portfolio = Change in yield

Example: [(1.51 – 1.23) x ($200,000)] / $10,000,000
= .28 x $200,000 / $10,000,000
= 56,000 / 10,000,000
= **.0056**

Step 3 – Evaluate results:

	Current	After proposed trade
Average life:	50 days	57.3 days
Portfolio yield:	1.45%	1.4556%

This type of analysis provides valuable information for effectively managing the average life of your portfolio. Whether or not you execute the trade depends on your interest rate outlook and investment strategy. The proposed trade would lengthen the average life by 7.3 days. If your maximum is 90 days, you would be using almost 20 percent of your available average life with virtually no impact on portfolio yield. But keep in mind, the value of a trade cannot be determined solely on the basis of its impact on the average life and yield of your portfolio. Those parameters, in conjunction with your interest rate outlook and policy limitations, must all factor into your decision as to the best method of implementing your investment strategy. Also, while the example above involves only one proposed trade, you will likely be considering several maturity options, e.g.,

continued on next page

six-month, one-year, two-year. Be sure to analyze and compare the impacts of all proposed trades in your decision-making process.

The first example focused on the impact to average life and yield of one investment of a certain size. But most often, portfolio management involves first targeting a particular average life and then looking for the best alternatives. Say, for example, you wanted to increase your average life by 30 days. Initially, you must determine your maturity options, then calculate the amount of each security necessary to reach that goal. Then you can evaluate the impact to your portfolio's yield:

Current Portfolio:

Size: $10,000,000 **Average life**: 185 days
Yield: 1.95% **Cash available**: $410,000 yielding 1.23%

Trade Option #1
2-Year Agency (730 days) yielding 1.80%

Trade Option #2
3-yr Agency (1,095 days) yielding 2.31%

Step 1 – How much must be purchased:
Formula: (Total portfolio x Number of days) / Life of proposed trade = Amount

Amount of Option #1
= (10,000,000 x 30) / 730
= 300,000,000 / 730
= $**410,000** ($410,959 rounded)

Amount of Option #2
= (10,000,000 X 30) / 1095
= 300,000,000 / 1095
= $**274,000** ($273,973 rounded)

Step 2 –Impact to yield:
Formula: [(Proposed trade yield - Cash yield) x (Par of proposed trade)] / Total portfolio = Change in yield

Impact of Option #1
= [(1.95 – 1.23) x ($410,000)] / $10,000,000
= (.72 x 410,000) / 10,000,000
= 295,200 / 10,000,000
= **+.0295**

Impact of Option #2
= [(2.31 – 1.23) x ($274,000)] / $10,000,000
= (1.08 x 274,000) / 10,000,000
= 295,920 / 10,000,000
= **.0296**

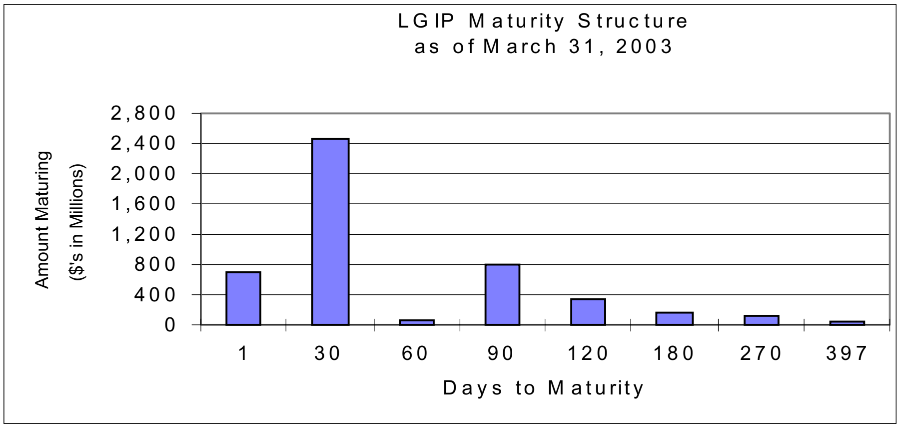
Resulting yield:
= 1.95 + .0295
= **1.9795%**

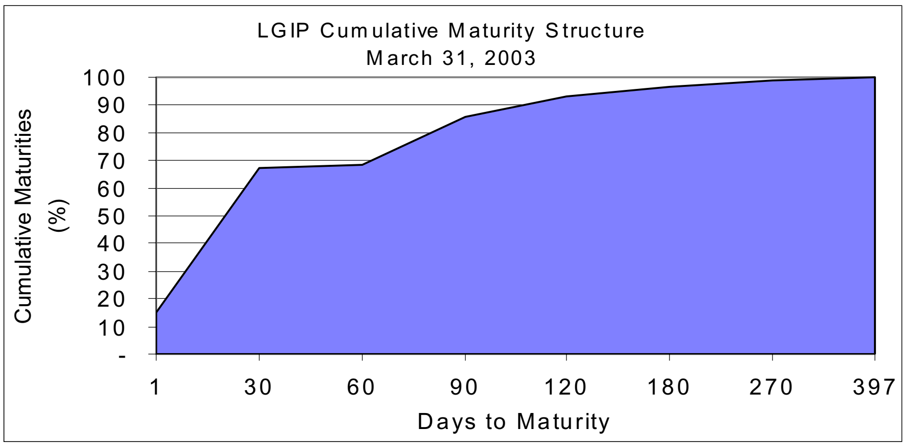
Resulting yield:
= 1.95 + .0296
= **1.9796%**

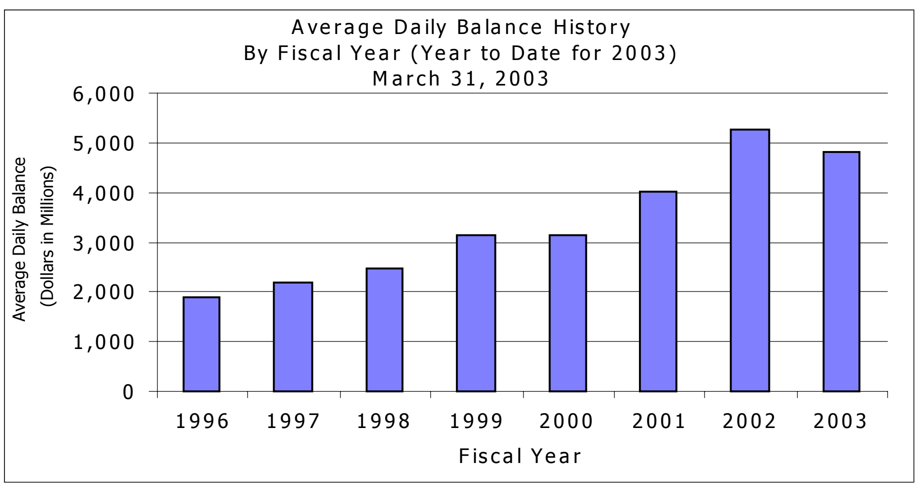
The above analysis is merely a tool for evaluating potential trades. The end result is not automatically a red or green light for trade execution. As discussed earlier, your decision must be a function of several parameters. For example, while the yield impact of the two options above is virtually the same, the two trades are not necessarily equivalent. Option #2 results in a slightly higher yield but leaves $136,000 in cash, which may be subject to positive or negative changes in interest rates. Clearly, trades that are appropriate for one portfolio and investment strategy may not be suitable for another. Careful evaluation of all options will help determine what's best for you.

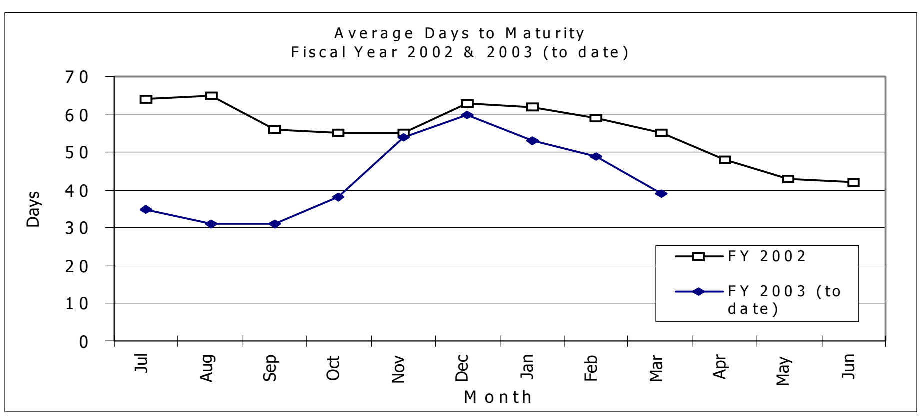
There are many combinations of investment strategies and endless trade scenarios. We've offered some tools to help in your assessment, but investment officers must come to their own conclusions about the best possible trades for their particular portfolios. We hope we've conveyed the value of managing the average life of your portfolio and the importance of carefully considering each trade option. Armed with an understanding of portfolio repricing and equipped with an appropriate method for evaluating the impact of a trade, you are better prepared to successfully manage your portfolio's average life and attain peak performance.

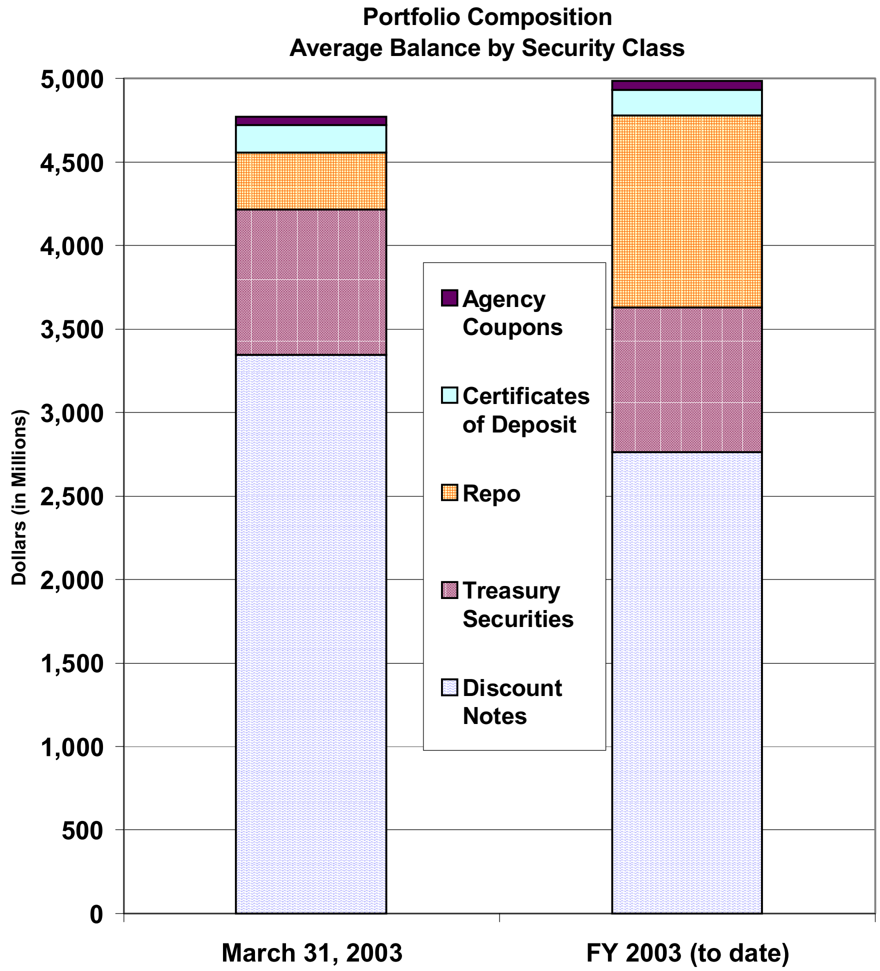
Now, suppose you have invested part of your available cash in a three-year security and wish to invest the remaining cash short-term. In our next article we'll study gap analysis – a means of evaluating short-term funding strategies on a break-even basis.


LGIP Maturity Structure
as of March 31, 2003
Amount Maturing ($'s in Millions)
2,800
2,400
2,000
1,600
1,200
800
400
0
1
30
60
90
120
180
270
397
Days to Maturity

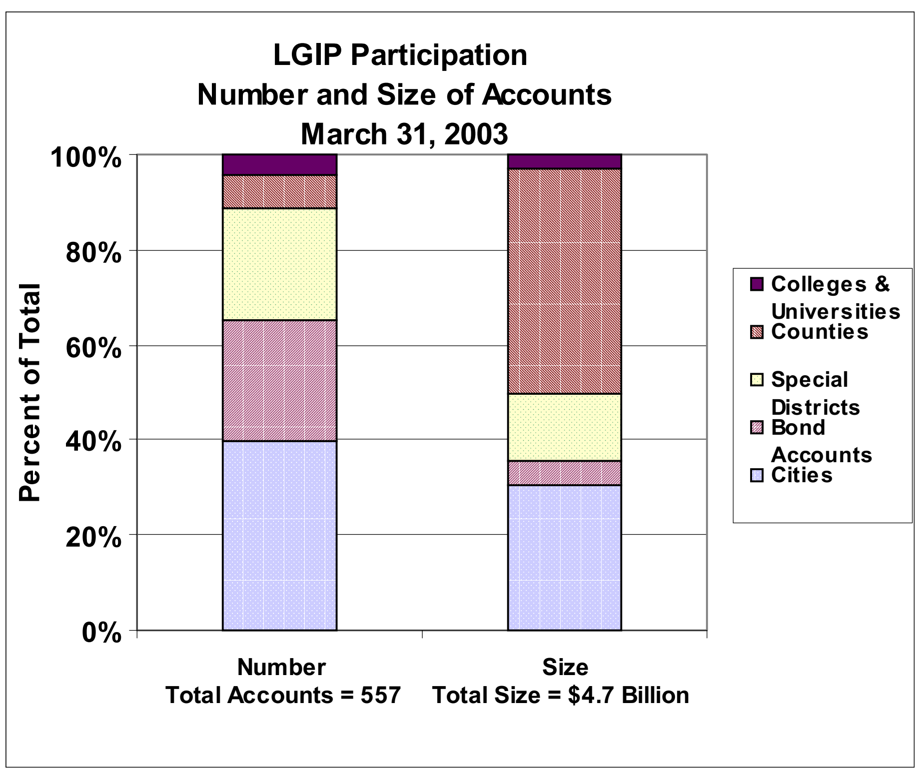

LGIP Cumulative Maturity Structure
March 31, 2003
Cumulative Maturities (%)
100
90
80
70
60
50
40
30
20
10
-
1
30
60
90
120
180
270
397
Days to Maturity


Average Daily Balance History
By Fiscal Year (Year to Date for 2003)
March 31, 2003
Average Daily Balance (Dollars in Millions)
6,000
5,000
4,000
3,000
2,000
1,000
0
1996
1997
1998
1999
2000
2001
2002
2003
Fiscal Year


Average Days to Maturity
Fiscal Year 2002 & 2003 (to date)
Days
70
60
50
40
30
20
10
0
FY 2002
FY 2003 (to date)
Jul
Aug
Sep
Oct
Nov
Dec
Jan
Feb
Mar
Apr
May
Jun
Month



Portfolio Composition
Average Balance by Security Class
5,000
4,500
4,000
3,500
3,000
2,500
2,000
1,500
1,000
500
0
Dollars (in Millions)
Agency Coupons
Certificates of Deposit
Repo
Treasury Securities
Discount Notes
March 31, 2003
FY 2003 (to date)



LGIP Participation
Number and Size of Accounts
March 31, 2003
100%
80%
60%
40%
20%
0%
Percent of Total
Colleges & Universities
Counties
Special Districts
Bond Accounts
Cities
Number
Total Accounts = 557
Size
Total Size = $4.7 Billion

Cash management strategies: The impact of transaction costs

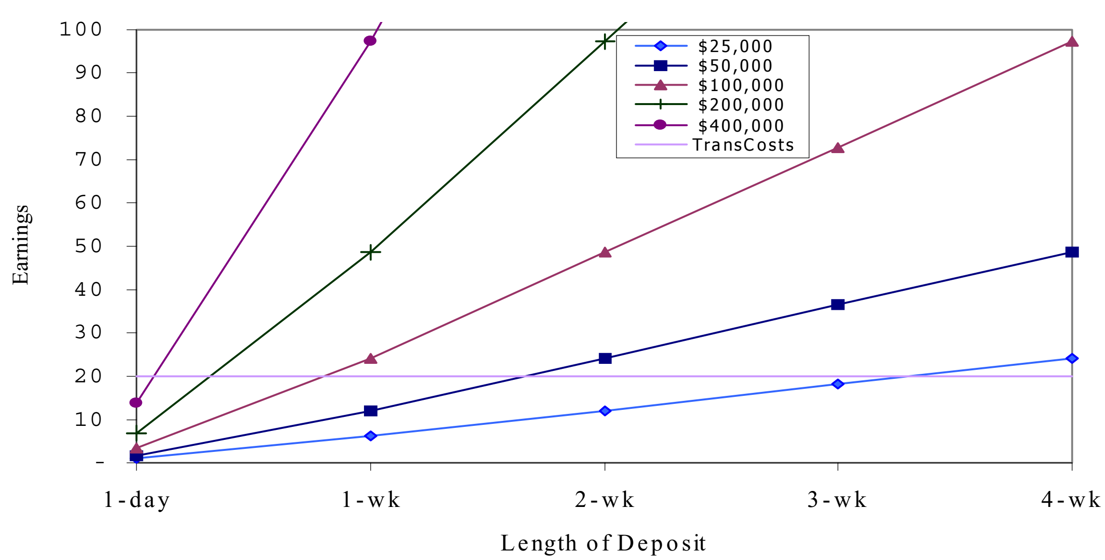
As professionals responsible for managing public funds, we all strive to improve the financial well-being of our state and local governments. Stretching every tax dollar is always a priority, especially when budgets are tight. However, what was once deemed efficient cash management is not necessarily so in today's low interest rate environment, particularly when considering transaction costs.

Transaction costs can have a significant negative impact on net earnings. Our historically low interest rates amplify that impact. For example, $100,000 invested in the LGIP for one day would have earned $17.93 in December 2000, when the net rate was 6.45 percent. But in March, when the net rate was 1.29 percent, that same investment earned just $3.58 – about 80 percent less.

Now, suppose you need that money back in five days, and your bank charges $20 for a round trip, i.e., money out and then in again. Taking wire fees into account, you would have realized a net gain of $69.65 in 2000, but a loss of $2.10 today. This example clearly illustrates the importance of considering transaction costs when planning your cash management strategies.

Your transaction cost/benefit analysis should include all expenditures involved in your cash management/investment activity. Costs such as wire fees, both out and in, and the time necessary for determining the transaction, notifying the bank and the LGIP, confirming the wire, and recording and auditing the transaction should all be considered.

Once you have determined what a transaction "costs," your next step is to evaluate the benefits. This involves cashflow estimates, followed by a breakeven analysis. The graph below shows the breakeven points for various deposit amounts. The results assume an LGIP net rate of 1.25 percent and a transaction cost of $20. The breakeven point represents the number of days it takes for the earnings to equal the transaction costs for a given deposit amount. It is a function of the LGIP net rate, transaction cost and transaction size.



Breakeven - Earnings vs. Transaction Costs (Earnings Rate - 1.25%)

For example, the breakeven point for $50,000 is currently 12 days if your transaction cost is $20. To determine where your breakeven points are, you can move the horizontal transaction cost line up or down according to your transaction costs. The general formula for calculating the breakeven point is as follows:

$$\text{Breakeven Point (in days)} = \frac{(\text{Transaction Cost}) \times (360)}{(\text{Deposit Amount}) \times (\text{LGIP Net Rate})}$$

For the example mentioned above:

$$\text{Breakeven Point} = \frac{(\$20) \times (360 \text{ days})}{(\$50{,}000) \times (0.0125)}$$

$$= 11.52 \text{ Days}$$

continued on page 10

Washington State Local Government Investment Pool
Position and Compliance Report
as of 03/31/2003
(Settlement Date Basis)

LGIP Portfolio Holdings

		Cost	Percentage of Portfolio
Agency Bullets	$	50,125,840	1.07
Certificate of Deposit		110,150,000	2.35
Discount Notes		2,652,290,008	56.54
Liquidity Deposits (MIA)		50,316,746	1.07
Repurchase Agreements		1,601,476,000	34.14
U.S. Treasuries		176,998,032	3.77
U.S. Treasury Bills		49,767,278	1.06
***Total Excluding Securities Lending**	$	4,691,123,904	100.00

Securities Lending Holdings

	(updated on day lag) Cost
Repurchase Agreements	236,651,006
Total Securities Lending	236,651,006

Total Investments & Certificates of Deposit $ 4,927,774,909

Policy Limitations

*The policy limitations include investment of cash collateral by a securities lending agent calculated as percentages of the portfolio holdings Total Excluding Securities Lending.**

Size Limitations

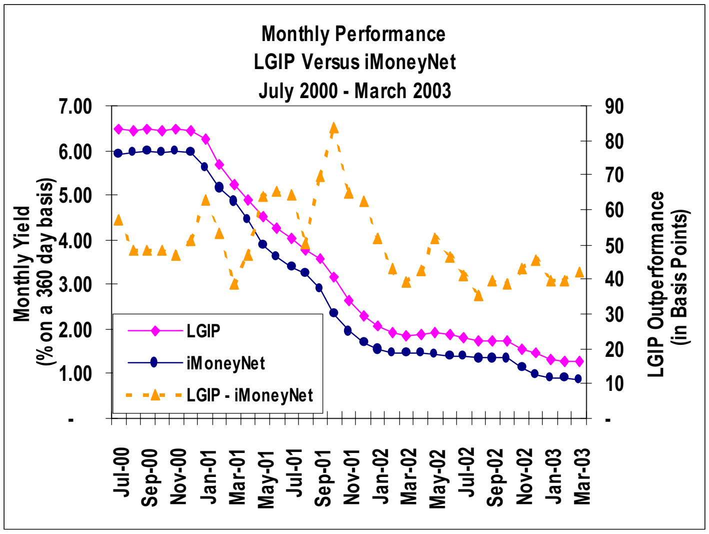
	Portfolio Holdings	Portfolio Percentage	Policy Percentage
Certificate of Deposit	110,150,000	2.35	10%
Leverage - Sec Lend + Rev Repo	236,651,006	5.04	30%

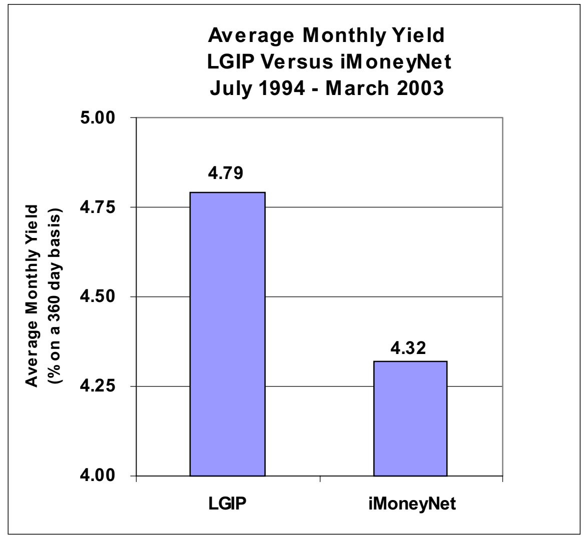
Maturity Limitations (Days)	Currently	Policy
Average Life	38	90
Maximum Maturity	366	397
Maximum Maturity of Repos	10	180
Maximum Maturity of Reverse Repos	0	90

Repo Limits Per Dealer	March 31, 2003	Total Repo Percentage (20% limit)	Term Repo Percentage (10% limit)	Projected Redemptions 04/01/2003	Projected Position 04/01/2003
Banc One Capital Mkts	200,000,000	4.26%	4.26%	-	200,000,000
Bear Stearns & Co.	200,000,000	4.26%	4.26%	-	200,000,000
Goldman Sachs	436,651,006	9.31%	4.26%	236,651,006	200,000,000
Greenwich Capital	300,000,000	6.40%	4.26%	100,000,000	200,000,000
Lehman Brothers Inc.	301,476,000	6.43%	0.00%	301,476,000	-
Merrill Lynch	200,000,000	4.26%	4.26%	-	200,000,000
Morgan Stanley Dean Witt	200,000,000	4.26%	4.26%	-	200,000,000
Total	**1,838,127,006**			**638,127,006**	**1,200,000,000**

LGIP Performance Comparison

iMoneyNet, Inc. [1]
versus
Local Government Investment Pool





The chart on the left shows a monthly comparison from July 2000 through March 2003 and how the LGIP has consistently outperformed the benchmark.

The chart on the right shows an average monthly yield comparison from July 1994 to March 2003. The LGIP net rate of return has outperformed its benchmark during that time period by an average of 47.3 basis points. This translates into the LGIP earning $122.85 million over what the average comparable private money fund would have generated.

[1] Average Net Rate of Return of Government Only/Institutional Only Money Market Funds, Money Market Insight, iMoneyNet, Inc., Westborough, MA. This benchmark is comprised of privately managed money market funds similar in composition and investment guidelines to the LGIP.

Cash management strategies: The impact of transaction costs

from page 8

Using this example, if you know that you'll need that money back in the next week or so, you would be better off simply leaving the money in your bank account. Furthermore, many banks offer a credit towards monthly bank fees for balances left in the account, so you could actually receive a fee reduction if you leave the money in the bank.

Our objective is to educate public funds managers and offer support in efficient investments and cash management. We do not, in any way, discourage use of the LGIP as an investment alternative. For nearly 17 years the LGIP has been a sound investment option for local governments. However, in the current environment, with budgets squeezed and interest rates at historic lows, we want to help ensure maximum value on investments.

To assist in analyzing past LGIP activity, TM$ users can export account ledger reports to an Excel spreadsheet. This allows evaluation of LGIP transactions as far back as July 1999. If you have questions about exporting reports, or if you do not have access to TM$ and would like reports sent to you, contact Jen Thun, LGIP Administrator, at 800-331-3284.

Local Government Investment Pool

STATEMENT OF NET ASSETS
March 31, 2003

Assets	
Investments, at Amortized Cost:	
Repurchase Agreements	1,601,476,000
U.S. Agency Coupons	50,125,840
U.S. Agency Discount Notes	2,652,290,008
U.S. Treasury Securities	226,765,310
Total Excluding Securities Lending & Securities Purchased But Not Settled	4,530,657,158
Securities Lending Investments, at amortized cost:	
Repurchase Agreements	236,651,006
Total Investments (Settlement Date Basis)	4,767,308,164
Due from Brokers - Securities Purchased But Not Settled, at Amortized Cost:	
U.S. Agency Discount Notes	199,905,111
Total Investments (Trade Date Basis)	4,967,213,275
Certificates of Deposit	160,466,746
Cash	140,066
Interest Receivable	2,863,496
Total Other Assets	163,470,308
Total Assets	5,130,683,583
Liabilities	
Accrued Expenses	284,372
Obligations under Securities Lending Agreement	236,651,006
Investment Trades Pending Payable	199,905,111
Total Liabilities	436,840,489
Net Assets	$ 4,693,843,094
Participant Net Asset Value, Price per Unit	$ 1.00
Total Amortized Cost - Settlement Date Basis	$ 4,927,774,910

QUARTER AT A GLANCE
January 1, 2003 - March 31, 2003

Total investment purchases:		$ 17,973,521,982
Total investment sales:		$ 2,004,107,651
Total investment maturities:		$ 15,891,896,000
Total net income:		$ 14,720,963
Net of realized gains and losses:		$ 333,355
Net Portfolio yield (360-day basis):		
	January	1.3121%
	February	1.2829%
	March	1.2865%
Average weighted days to maturity:		38 days

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